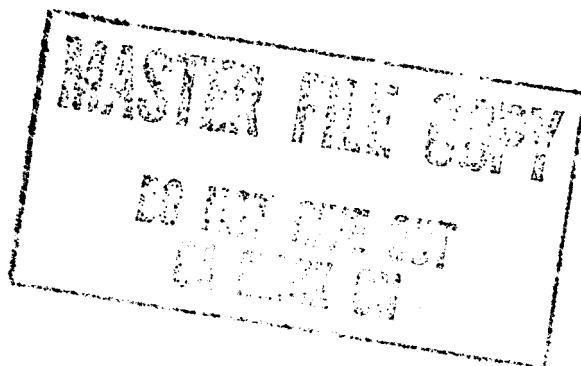




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Brazil: Shifting Economic Priorities



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An Intelligence Assessment

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Brazil: Shifting Economic Priorities



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An Intelligence Assessment

*Information available as of 5 February 1982
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This paper was prepared by 
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may be directed to the Chief, South America Division,



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**Brazil: Shifting
Economic Priorities**

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Key Judgments

Brazilian Planning Minister Delfim Netto last year implemented economic austerity policies to avert a crisis in relations with foreign bankers. Delfim's measures slowed the economy, thereby improving the payments accounts, restoring Brazil's tarnished international creditworthiness, and reducing triple-digit inflation.

Despite a public commitment to continued austerity, however, Brasilia is now engineering a gradual economic recovery through increased government spending and loosened monetary restraints. Consequently, we expect 3- to 5-percent real growth in 1982, accompanied by inflation in the 75- to 80-percent range and a current account deficit of about \$11 billion.

The near-term outlook is reasonably positive, but policy miscalculations or the resumption of rapid growth would trigger another price spiral and cause renewed payments problems to undermine creditor confidence. Additionally, new external shocks or unanticipated difficulties with debt servicing could upset Brasilia's plans. Even if these risks are averted, an effective stabilization program requires Brasilia's continued willingness to control growth, increase investments in resource-based industries, and sustain an export advance that would improve debt-carrying capacity.

The United States has a substantial stake in Brazil's future. US banks and multinational corporations have more than \$20 billion invested in Brazil. Serious financial strains could result if Brazil encountered debt servicing difficulties or if it adopts more restrictive foreign investment policies. Beyond this, aggressive Brazilian export marketing policies and sustained import barriers have the potential to spark conflict with the United States.

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Brazil: Economic Indicators

Note change in scales

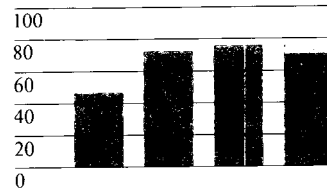
Real GDP Growth
Percent^a



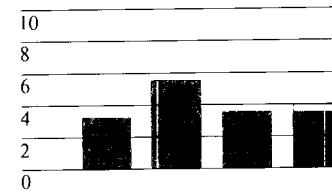
Cost of Living
Percent^a



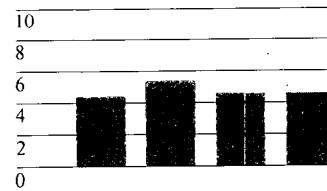
Monetary Expansion
Percent^a



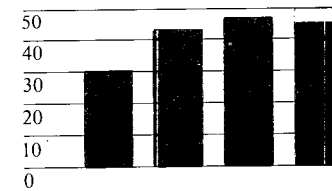
Government Deficit
Percent of GDP



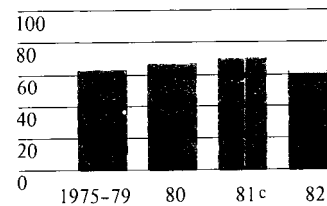
Current Account Deficit
Percent of GDP



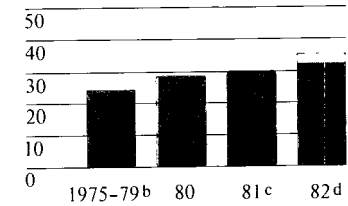
Oil Imports
Percent of Total Imports



Debt Service
Percent of Merchandise Exports



External Debt^b
Percent of GDP



^a Average annual.

^b Short- and long-term obligations.

^c Estimate.

^d Projected.

Brazil: Shifting Economic Priorities

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The Switch to Restrictive Policies

By late 1980 Brazilian Planning Minister Delfim Netto's growth-oriented policies were devastating the economy. Stimulative fiscal and monetary policies implemented in mid-1979 had led to economic overheating and triple-digit inflation. Delfim's policy of imposing ceilings on indexation adjustments fueled speculation, encouraged the diversion of saving into consumption, and led to an overvalued exchange rate. Despite a strong advance in exports, the current account deficit worsened because of soaring imports and rising interest payments. Brazil encountered growing difficulty in arranging long-term foreign financing to cover the payments gap and resorted to reserve drawdowns and short-term borrowing to avert a financial crisis. Foreign bankers demanded that Brasilia submit to an International Monetary Fund stabilization package.

In November 1980 Delfim announced an austerity program designed to improve Brazil's economic performance and regain creditor confidence. Macroeconomic policies were tightened to slow the economy, reduce inflation, and restrain imports. Brasilia announced restrictive monetary expansion targets, reduced subsidies to nonpriority sectors, and imposed budget restraints on the powerful state corporations. The government abandoned policies that created inefficiency in the economy. Many price controls were lifted, while the cost of nonsubsidized bank credit was allowed to rise to free market levels. To enhance export competitiveness, the government also returned to its policy of frequent, small devaluations in line with the actual rate of inflation.

Despite the past commitment to rapid growth, Delfim encountered little real opposition to the austerity program. Key political and business decision makers—the moderate military, government politicians, technocrats, and foreign investors—supported austerity to avoid plunging the country into an international financial crisis and to lay the foundation for

Table 1

Brazil's International Economic Standing, 1981

Gross domestic product	\$240 billion, 20 percent of non-OPEC LDC total, World's 10th largest.
Population	122 million, 6 percent of non-OPEC LDC total, World's sixth largest.
Long-term foreign debt	\$ 61 billion, 30 percent of non-OPEC LDC total, \$17 billion in US commercial bank holdings.
Debt service	\$16 billion, 35 percent of non-OPEC LDC total, \$5 billion paid to US institutions.
Foreign direct investment ^a	\$18 billion, 15 percent of non-OPEC LDC total, \$5 billion US exposure (stock).
Exports	\$23 billion, 10 percent of non-OPEC LDC total, \$4.0 billion shipped to United States.
Imports	\$22 billion, 10 percent of non-OPEC LDC total, \$3.6 billion received from United States.
Oil imports	\$11 billion, 15 percent of non-OPEC LDC total, Third World's largest bill.

^a Stock at yearend 1981.

improved economic performance. Businessmen took advantage of the slowdown to improve profit margins by reducing labor costs and pruning product lines. Labor remained quiescent in the face of mounting layoffs. Church leaders, the media, and opposition politicians also muted criticism of the government's economic policies.

Last Year in Perspective

The Pluses. In 1981 Brasilia implemented some of the policies necessary to improve long-run economic performance. The switch to austerity policies enabled the government to stem the widespread economic deterioration that had taken place since 1979. Moreover, the slowdown forced businessmen to improve productivity. Important first steps were also taken to strengthen policy implementation. Quarterly targets were imposed on the credit operations of the banking system, and some centralized controls were placed on the operations of state enterprises. The greater emphasis on free market forces improved efficiency. The elimination of ceilings on indexation adjustments helped rid the economy of price speculation and the tendency to switch from savings to real estate and consumer durable purchases. Price and interest rate decontrol improved business profit margins, reduced consumption, and prevented speculative stockpiling. []

Brasilia also showed progress in making the structural adjustments needed to lessen external constraints to growth. Despite the international economic slowdown, Brazilian exports advanced 16 percent to the \$23 billion level, thereby improving debt-carrying capacity. Higher agricultural support prices and expanded rural credit facilities again induced the increased plantings necessary to achieve self-sufficiency in most domestic food production and to realize higher agricultural export earnings. The government accelerated investments required to develop untapped mineral reserves. Additionally, Brasilia made progress in lessening dependence on foreign oil by price-induced conservation, switching petroleum users to nonoil energy, and increasing domestic oil production. []

The Minuses. Despite these achievements, Delfim faced growing difficulties in sustaining restrictive policies as the year wore on. Public finances did not perform as originally programed, and this contributed to serious monetary pressures. Brazil's powerful state corporations successfully challenged budget restraints; they increased spending by 120 percent, well above the rate of inflation. Moreover, the ailing social security system posted an estimated 215-billion-cruzeiro (\$2 billion) deficit.¹ The Treasury cash surplus

¹ Brazil's average annual exchange rate was 93.1 cruzeiros per dollar in 1981. []

Table 2

Brazil: Austerity Takes Hold

Economic growth fell off sharply in 1981. The decline in demand halted the strong industrial boom that had been under way since mid-1979. Despite another bumper crop and strong export gains, Brazil's real GDP rose only an estimated 1 percent in 1981, compared with the strong 8-percent gain in 1980.

Inflation began to decline. Tight economic policies, favorable harvests, and a slowdown in oil price hikes caused a gradual deceleration in the inflation rate. Measured on a 12-month basis, the general price index fell from a peak of 121 percent in March 1981 to 95 percent at yearend.

Brazil's trade accounts posted steady improvements. Despite weakening prices for its major agricultural exports, Brazil achieved major trade gains by posting an estimated \$1.2 billion trade surplus in 1981, compared with a \$2.9 billion deficit in 1980.

Growing interest payments on Brazil's accumulated foreign debt partially offset these gains. The current account deficit declined about 18 percent to \$10.6 billion. Brazil also required some \$8 billion to roll over maturing loans.

Brazilian borrowers smoothly obtained the necessary foreign funding. International bank confidence—the key factor—was strengthened by Brasilia's success in implementing necessary stabilization policies.

had been reduced 12 percent to 80 billion cruzeiros (about \$900 million) by the end of November 1981 compared with the same period in 1980 because expenditure growth outpaced revenue gains. At the same time, the continued use of subsidized credit in support of agricultural, export, and energy programs undermined the efforts of the monetary authorities to slow the growth of the money supply. With a 17-percent expansion of the monetary base in December, the 12-month increase in the money supply rose to 72 percent, compared with the 50-percent target. []

Brasilia also failed to eliminate some serious impediments to improved economic performance. The government had to reintroduce export-tax rebates and step up the use of subsidized credit to sustain the

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Table 3

Brazil: Survey of Economic Forecasts, 1982

Resources	Data Resources Inc. ^a	Brazilian Government * ^b	Suma Economica * ^c	GM do Brasil * ^d	US Embassy ^e	CIA ^f
Percent						
Real GDP	0.1	5.0	5.0	3.1	3.0	3-5
Inflation	90.7	80.0	72.5	85.0	75.0	75-80
Monetary expansion	68.4	50.0	70.0	70.0	NA	75
Billion US \$						
Trade account balance	2.9	3.0	2.0	2.2	2.5	2.0
Current account balance	-9.0	-10.1	-12.8	-10.3	-10.4	-10.7 to -11.4
External debt, yearend	68.4	69.0	69.4	71.0	NA	70

* Brazilian sources.

^a Published February 1982.

^b National Monetary Council basic forecast published in December 1981.

^c Published November 1981.

^f Published 5 February 1982.

export advance in the face of an overvalued cruzeiro. Sustained import barriers contributed to inefficiency by shielding high-cost domestic manufacturers from foreign competition. Finally, Brasilia continued to shy away from several key financial reforms necessary to strengthen future economic performance; for example, the IMF estimates that 71 percent of all Brazilian credits are lent at subsidized rates, leading to the inefficient allocation of investment funds and capital market distortions. Finally, political constraints also prevented Delfim from modifying the semiannual wage adjustment policy which continues to feed cost-push inflation. [redacted]

Further Policy Changes Under Way

Delfim faces an important test in 1982. Brasilia must sustain restrictive policies to strengthen the external accounts and to reduce inflation. Moreover, policy-makers also recognize the need for new financial reforms to improve overall economic performance. Vested interests, however, are pressing for a growth-oriented strategy. Industrial spokesmen have stepped

up lobbying for a relaxation of tight policies. They fear that continued fiscal and monetary restraint will deepen and prolong the recession, undermine incentives for foreign borrowing, and dampen new investment, thus reducing the ability to expand manufactures exports. Much of the Brazilian media has recently increased editorializing on the need to reactivate the economy to avoid social unrest. Moreover, opposition politicians, the liberal clergy, and militant labor leaders can be expected to criticize the government austerity program before the elections scheduled for November 1982. [redacted] 25X1

Publicly, the government continues to support the austerity program. Key economic ministers have stressed in speeches and interviews that in 1982 tight policies and economic controls on state enterprise spending would continue and new financial reforms would be initiated, especially those aimed at reducing subsidies. Key macroeconomic targets remain restrictive. Against a projected 80-percent rate of inflation,

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for example, the National Monetary Council approved in late December 1981 a 50-percent expansion of the money supply. Moreover, the government recently raised social security taxes and announced an excise tax on luxury goods in an attempt to close the large social security deficit. []

Despite this public posture, many economists believe that Brasilia is seeking to spur a limited recovery. (See table 1 for a range of economic projections for 1982.) The government revealed plans for a new public works program in late 1981 aimed at creating some 100,000 new jobs this year. Moreover, government spending has been programed to increase at rates slightly above anticipated inflation. State corporations—accounting for some 40 percent of total sales in Brazil—will receive an 86-percent increase in operating budgets and an 83-percent increase for investment spending in 1982. Other state and local spending, funded by revenue transfers from the federal government, is also expected to provide expansionary momentum. State budget expenditures for 1982 are projected to increase by 109 percent in Sao Paulo, 116 percent in Rio de Janeiro, 129 percent in Minas Gerais, and 175 percent in Rio Grande do Sul. []

The monetary authorities are also implementing some expansionary policies. In late October, for example, the National Monetary Council voted a small spending supplement. The council also eased repayment terms on consumer credit to aid the ailing durable goods producers. Moreover, finance companies will now be allowed to borrow in foreign markets to finance working capital loans for small- and medium-sized companies. Taken together, these fiscal and monetary changes will probably ensure an economic upturn in 1982. Delfim has stated economic growth will rise to 5 percent in 1982, a target designed to reactivate the economy without spurring inflation. []

Economic Signs To Watch

Given Delfim's poor economic management record since 1979, Brasilia's effort to engineer a gradual economic recovery is risky. The major factors that could cause Brazil's economic performance to diverge from the baseline scenario include:

- Overstimulating the economy because of the inability to control state corporation spending, failure to

restrain the growth in subsidy payments or the money supply, the initiation of new pork barrel projects to aid government electoral prospects, and tax revenue shortfalls.

- Debt servicing difficulties arising from unanticipated external jolts, a serious erosion of Brazilian firms' debt repayment capabilities, or any prolonged slowdown in foreign lending because of the loss in creditor confidence.
- The reintroduction of rapid-growth policies following any increase in the number of social incidents—cost-of-living demonstrations, labor conflicts—aimed at reducing economic frustrations. []

Policy miscalculations by Delfim could again cause Brazil to face serious economic problems toward the end of 1982. The failure to maintain fiscal or monetary discipline could cause renewed triple-digit inflation. Despite Brazilians' noted toleration, popular concern over rising prices could spark growing labor restiveness, social protests, and increase the chance of government losses in the scheduled November elections. More serious economic backsliding probably would trigger a subsequent financial showdown between Brazil and its foreign creditors. Any severe deterioration in the external accounts probably would begin to undermine creditor confidence and cause Brazil growing foreign financing difficulties. []

Despite these pressures, a major social upheaval is unlikely. The Brazilian tradition of compromise, the lack of a class consciousness among the poor, and the absence of a charismatic popular leader militate against serious unrest over the near term. The possibility cannot be excluded, however, that worsening economic problems could force a change in Delfim's economic policy team. If such a change were based on a perceived need to improve Brazil's balance-of-payments position, the result might be harsher austerity policies and sharply slower growth in 1983. Alternatively, a preoccupation with developing Brazilian industry could lead to the implementation of growth-oriented policies. Brasilia's choice in such a contingency is unclear and would depend heavily on the personality of Delfim's successor. []

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The Near-Term Outlook

Economic Growth. Economic growth—which slowed to 1 percent in 1981—should recover modestly. Real GDP will probably expand in the 3- to 5-percent range as a result of:

- Recovery in the industrial sector spurred by the need to rebuild inventories, the loosening of restrictive policies, and expanded export credit facilities.
 - Increased state corporation investments, especially in mining and energy projects.
 - Solid gains in the service sector induced by new civil construction projects and industrial expansion.
- Any substantial world economic improvements could be translated into a stronger-than-expected recovery.

Inflation. Brasilia should make continued progress against inflation this year. Consumer resistance to new price hikes, the existence of idle industrial capacity, and stable international oil prices should help restrain inflationary momentum. Nevertheless, the core inflation rate will remain high because of a continuing large budget deficit, rapid monetary expansion, and less favorable agricultural performance. Brazil's inflation is likely to range between 75 and 80

percent this year, compared with 95 percent in 1981 (December over December).

External Accounts. Brasilia is expecting further improvement in its external accounts. The government is projecting a \$3 billion trade surplus and a \$10 billion current account deficit. We believe these targets are slightly beyond reach. The current account deficit will likely hover in the \$11 billion range, while the trade surplus will likely be limited to \$2 billion. On top of the current account deficit, Brazil will require another \$7 billion to meet repayments on maturing loans. Allowing for \$1.5 billion in new direct investment and no reserve changes, Brazil will need \$16-17 billion in loan inflows again this year.

At this juncture, lender confidence remains high. Entering 1982, Brazilian borrowers will encounter little difficulty in obtaining new loans or rolling over maturing credits. We cannot judge, however, how bankers will react to stronger growth as the year wears on. Perceptions of economic backsliding could cause creditors to stall on new loans syndications, thus setting the stage for renewed financial difficulties.

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Longer Term Challenges

Brazil will continue to face serious economic challenges. The Figueiredo government must balance the desire for rapid growth against the need for reforms to improve long-run economic performance. Policy shifts since mid-1980 are delineating the broad outlines of Brasilia's evolving adjustment strategy for the 1980s:

- Macroeconomic policy probably will be set to achieve 4- to 6-percent real growth, a rate sufficient to avert social tensions, reduce inflationary pressures, and improve the external accounts.
- Development priorities will continue to emphasize agriculture, mineral projects, and indigenous energy sources to lessen external constraints on future growth.

- External policy will rely on export promotion to improve debt-carrying capacity and continued large-scale foreign borrowing to close the balance-of-payments gap.
- Financial reforms will be gradually implemented to improve economic management, eliminate subsidies, and improve allocative efficiency throughout the economy.

The consistent pursuit of these objectives would lead to a steady improvement in Brazil's economic performance through mid-decade.

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Billion US \$

**Brazil:
Balance of Payments**

	1980	1981 ^a	1982 ^b
Trade balance, f.o.b.	-2.9	1.2	2.0
Exports	20.1	23.3	26.8
Imports	23.0	22.1	24.8
Service balance	-10.2	-12.0	-12.9 to -13.6
Net interest	-6.3	-8.5	-9.0 to 9.7
Other services	-3.9	-3.5	-3.9
Transfers	0.2	0.2	0.2
Current account balance	-12.9	-10.6	-10.7 to -11.4
Amortization	-5.0	-7.8	-7.0
Reserve drawdowns	3.5	0	0
Foreign capital requirements	14.4	18.4	17.7 to 18.4
Financed by			
Foreign investment, net	1.6	1.5	1.5
Loan inflows	13.2	17.2	16.2 to 16.9
Errors and omissions	-0.4	-0.3	0

^a Estimated.^b Projected.

Numerous pitfalls, however, could hamper Delfim's ability to sustain this long-term strategy:

- Delfim has relinquished his decree power to impose wage controls that could restrain inflationary pressures.
- Vested interest groups are becoming more effective in lobbying for shifts in economic policies.
- After a decade of unrestricted operation, the state corporations are proving difficult to bring under centralized control.

These events magnify the inherent problems of managing from isolated Brasilia a complex economy that has long had two economic capitals—Sao Paulo and Rio de Janeiro.

The failure to address economic reforms will hinder adjustments. Thus far, Brasilia has not consolidated government budgets and dismantled the extensive subsidy system. The slow pace of reform has resulted

in continuing government deficits that hinder slowing growth in the money supply. To contain inflationary pressure, Brasilia has resorted to heavy sales of government securities to mop up the excess liquidity. Without a large domestic equity market and long-term sources of debt capital, the reduced availability of credit for the private sector also contributes to a slowdown in the rate of new investment, thereby undermining Brazil's future economic vitality.

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External shocks also can devastate the adjustment program. With foreign oil purchases now at some 800,000 barrels per day, each \$1 increase in crude prices adds about \$300 million to Brazilian import requirements. More immediately important, a 1-percentage-point rise in the London Interbank Offer Rate base rate now causes an increase of \$400-500 million in annual debt servicing costs. Agricultural export shortfalls, higher unit import prices, or a slowdown in the rate of foreign direct investment inflows would also complicate the government's ability to sustain adjustments.

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Economic inefficiency will plague the Brazilian economy. Brazil's famed indexation system, for example, is now perpetuating inflation and sheltering inefficient firms from competitive forces. Import barriers have added to cost-push inflation while protecting high-cost domestic industries from foreign competition. According to a World Bank study, the Brazilian financial system has become a major cause of the misallocation of investment resources. Additionally, the lack of collective bargaining has hindered efforts to improve productivity.

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These combinations of factors cloud Brazil's economic outlook beyond 1982. The government's political unwillingness or technical inability to sustain adjustments could result in stop-go economic cycles, high inflation, and periodic payments difficulties. Social stresses would be likely to mount because of the failure to create an adequate number of new jobs, real wage stagnation, and periodic belt-tightening to satisfy foreign creditors. Even so, it is unlikely that these strains would lead to destabilizing violence because of

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the government's probable willingness to offer selected concessions to vested interests in order to allay discontent and smooth over accumulating economic frictions. []

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With only a thin margin for error, however, policy miscalculations or unexpected external shocks could lead to severe economic deterioration. Intense pursuit of economic growth, especially by any development-minded successor to Delfim, could spur hyperinflation, thereby undermining savings incentives, restraining the rate of new investment, contributing to allocative inefficiency, and distorting the exchange rate. Economic stagflation would soon follow. The consequences of unremitting economic deterioration—a prospect we now assign a low probability—could be severe:

- Economic deprivation would heighten prospects for social unrest.
- Political liberalization could be halted or reversed, setting the stage for major political unrest.
- Brazil would be susceptible to the appeals of a far more nationalistic leadership.
- The likelihood of a major foreign exchange crisis and debt rescheduling would increase, thereby restricting Brazil's access to foreign capital and undermining the country's future economic vitality. []

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Implications for the United States

The United States has a substantial stake in Brazil's continued stability and progress. Brazil remains one of the largest markets for US overseas loans. US banks have extended \$17 billion in long-term loans and a substantial amount of short-term credit. For the near future, Brazil is likely to remain a secure location for US investments. Even so, debt servicing difficulties will continue to pose the major near-term risk. Despite Brazil's impressive export advance, debt servicing payments will equal 60 percent of merchandise export earnings. Several of the largest US financial institutions—Citicorp, Chase Manhattan, Morgan Guaranty—could suffer seriously if Brasilia encounters debt servicing difficulties. []

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US corporations have also played a substantial role in Brazil's economic development. Direct US investment, mainly concentrated in the manufacturing sector, totaled an estimated \$5 billion at the end of 1981. Brasilia recognizes that foreign investment remains

essential to the country's continued economic development. Even so, the government's open-ended encouragement for nearly all foreign investment has given way to more restrictive policies. Since the mid-1970s, Brasilia has reserved selected markets for domestic firms, required greater local participation in new projects, and tightened rules governing technology transfer payments. Moreover, Brazilian payments problems have led the government to demand additional economic advantages and sacrifices—increased exports, more equity investment, fewer imports—from multinational corporations. Despite Brazilian pragmatism, US and other foreign investors are likely to encounter continued difficulties in investing and operating in the large Brazilian market in the future. []

Brasilia has become more aggressive in the pursuit of its economic self-interest. To improve the payments accounts, the government has aggressively promoted exports worldwide, especially to Third World countries and the Soviet Bloc. Brasilia has also moved to diversify its sources of foreign equipment, development loans, and technological assistance. Consequently, the Brazilian Government has demonstrated reluctance to support policies perceived unfavorable to its worldwide commercial interests. Despite US representations, Brasilia refused to apply trade sanctions against the Soviets in 1980. []

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US preoccupation with Brazil's aggressive export marketing may obscure the steady erosion of the US competitive position in the growing Brazilian market. The US share of Brazil's nonoil imports has declined from 42 percent in 1970 to 32 percent last year while the US share of cumulative direct investment dropped from 40 percent in 1970 to about 30 percent in 1981. This long-term decline could accelerate in the wake of European and Japanese efforts to increase their participation in Brazilian development projects. Over the longer term Brazil has the potential to become the most formidable of the newly industrializing countries (NICs). Brazil's situation is unique among the NICs in that it is a major supplier of raw materials and of manufactures both to the industrial countries and to

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the Third World. Brazil has substantial natural resources, enormous agricultural potential, a large internal market, and a favorable industrial wage structure. Brazil is well placed among the NICs for the longer term penetration of Third World markets and has already established a reputation for exporting machinery and other capital goods technologically adapted to Third World conditions.

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Brazilian import policies pose still another bilateral commercial irritant. Brazil's high tariffs, temporary import taxes, and limits on royalty payments and technical assistance fees inhibit the import of goods, services, and technology. Moreover, Brasilia continues to rely on tax rebates and subsidized financing to sustain exports of manufactured goods. US businesses could become increasingly vocal in demanding improved access to Brazil's large domestic market or the application of countervailing duties on Brazilian export products.

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